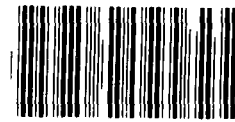


July 1986

FINANCIAL AUDIT

Federal Savings and Loan Insurance Corporation's 1985 and 1984 Financial Statements



130287

Comptroller General
of the United States

B-114893

July 2, 1986

To the President of the Senate and the
Speaker of the House of Representatives


This report transmits our opinion on the Federal Savings and Loan Insurance Corporation's financial statements for the years ended December 31, 1985 and 1984, and our reports on the Corporation's system of internal accounting controls and compliance with laws and regulations.

The Federal Savings and Loan Insurance Corporation, a wholly owned government corporation governed by the Federal Home Loan Bank Board, is responsible for insuring deposits in savings institutions. The Comptroller General is required by 31 U.S.C. 9105 to audit the financial transactions of wholly owned government corporations. We conducted our examinations in accordance with generally accepted government auditing standards.

Troubled sectors of the savings and loan industry have placed a severe strain on the Corporation. Its 1985 financial statements include \$5.2 billion in provisions for loss contingencies which were established for (1) closed institutions whose assets are being liquidated, (2) open institutions which are being provided financial assistance, and (3) those troubled institutions which will require new or increased financial assistance. This latter estimate focuses on near-term losses. It is not a projection of the cost of resolving all future problems in the industry. The Corporation's insurance reserves exist to provide for these future losses. As of December 31, 1985, the Corporation's insurance reserves were \$4.6 billion.

Currently, the Corporation estimates that more than 200 institutions will have to be assisted over the next 5 years at a cost of \$16 billion to \$22 billion. In response to this demand on the Corporation's insurance resources, the Congress is considering legislation (S. 2491 and H.R. 4907) to recapitalize the insurance fund through a new financing corporation. The capital infusion provided by the financing corporation, combined with the current reserves, projected member assessments, and investment income, could increase available insurance resources to about \$30 billion over 5 years.

We are sending copies of this report to the Director of the Office of Management and Budget, the Secretary of the Treasury, and the Chairman of the Federal Home Loan Bank Board.

A handwritten signature in cursive script, reading "Charles A. Bowsher".

Charles A. Bowsher
Comptroller General
of the United States

Contents

Opinion Letter	6
Report on Internal Accounting Controls	8
Report on Compliance With Laws and Regulations	10
Financial Statements	11
Comparative Statement of Financial Condition	11
Comparative Statement of Income and Expense and Reserves	12
Comparative Statement of Changes in Financial Position	13
Notes to Financial Statements	14

**Comptroller General
of the United States****B-114893**

To the Chairman
Federal Home Loan Bank Board

We have examined the statements of financial condition of the Federal Savings and Loan Insurance Corporation as of December 31, 1985 and 1984, the related statements of income and expense and reserves, and the changes in financial position for the years then ended. Our examinations were made in accordance with generally accepted government auditing standards and, accordingly, included such tests of the accounting records and such other auditing procedures as we considered necessary in the circumstances.

Troubled sectors of the savings and loan industry have placed a severe strain on the Corporation. The size of the savings and loan institutions that have failed and the number of institutions receiving financial assistance or special supervisory attention from the Corporation have steadily increased during the last several years. The Corporation's 1985 financial statements include \$5.2 billion in provisions for loss contingencies which were established for (1) closed institutions whose assets are being liquidated, (2) open institutions which have already been provided financial assistance, and (3) those troubled institutions the Corporation believes will ultimately require new or increased financial assistance.

Prior to 1985, the Corporation considered it impractical to estimate its contingent liability for those troubled institutions likely to require new or increased financial assistance. In 1985, the Corporation, as discussed in notes 1 and 13, began estimating potential losses attributable to those troubled institutions. This estimate focuses on near-term losses and is not a projection of the cost of resolving all future problems in the industry. The Corporation's insurance reserves exist to provide for other losses that may be incurred in the future in assisting the troubled industry. As of December 31, 1985, the Corporation's insurance reserves were \$4.6 billion.

Currently, the Corporation estimates that in excess of 200 institutions will have to be assisted over the next 5 years. Its cost estimate for providing this assistance ranges from \$16 billion to \$22 billion. A more precise estimate of future losses cannot be determined because of various uncertainties, such as the quality of each troubled institution's assets,

the level of interest rates, and legislation which may alter existing geographic and product restrictions that affect the savings and loan industry.

In response to this potentially significant drain on the Corporation's current and future resources, the Congress is considering legislation (S. 2491 and H.R. 4907) to recapitalize the insurance fund through a new financing corporation (see note 15) which would begin operations with about \$3 billion in capital provided by the Federal Home Loan Banks. The financing corporation would then raise additional funds for the Corporation by issuing long-term bonds. This new capital infusion, combined with the Corporation's current reserves, projected member assessments, and investment income, could increase available insurance resources to about \$30 billion over 5 years. The recapitalization should at least provide the monetary resources necessary for the Corporation to begin aggressively resolving the problems of this troubled industry.

Our opinion on the 1984 financial statements, dated May 10, 1985, was qualified as subject to the uncertain value of \$1.3 billion of assets on the 1984 statements that the Corporation acquired from three large savings and loan institutions which failed in 1984. In 1985, the Corporation charged to operations an allowance for loss necessary to reflect the net realizable value of those assets. Accordingly, our opinion on the 1984 financial statements is no longer subject to this qualification.

In our opinion, the financial statements referred to above present fairly the financial position of the Federal Savings and Loan Insurance Corporation as of December 31, 1985 and 1984, and the results of its operations and changes in financial position for the years then ended, in conformity with generally accepted accounting principles applied on a consistent basis except for the change, with which we concur, in the method of providing for estimated losses for those troubled institutions that will ultimately require new or increased financial assistance.



Charles A. Bowsher
Comptroller General
of the United States

June 6, 1986

Report on Internal Accounting Controls

We have examined the financial statements of the Federal Savings and Loan Insurance Corporation for the years ended December 31, 1985 and 1984, and have issued our opinion thereon. As part of our examinations, we made a study and evaluation of the system of internal accounting controls to the extent we considered necessary to evaluate the system as required by generally accepted government auditing standards. The primary objectives of our study and evaluation were to obtain an understanding of the control environment and the flow of transactions through the accounting system and to determine the nature, timing, and extent of the auditing procedures necessary for expressing an opinion on the Corporation's financial statements. This report pertains only to our study and evaluation of the system of internal accounting controls for the year ended December 31, 1985. (Our report on the study and evaluation of the system of internal accounting controls for the year ended December 31, 1984, is presented in GAO/AFMD-85-60, July 16, 1985.)

For the purpose of this report, we have classified the significant internal accounting controls into the following categories:

- assistance to problem savings and loan associations cycle,
- expenditure cycle,
- financial reporting cycle,
- revenue cycle, and
- treasury cycle.

Our study and evaluation was generally limited to a preliminary review of the system of internal accounting controls. Based on our preliminary review, we determined it was more efficient to expand substantive audit tests to verify account balances than to continue with a complete evaluation of internal accounting controls. However, we did evaluate the reliability of the controls over the timely posting of journal entries in all cycles, the appropriate authorizations of purchase orders in the expenditure cycle, the assessment of special premiums applied towards member institutions in the revenue cycle, and the proper processing and recording of compensation and benefit expenses and insurance premium income in the expenditure and revenue cycles, respectively. Therefore, with the exceptions noted, our study and evaluation of internal accounting controls did not extend beyond the preliminary review phase.

Corporation management is responsible for establishing and maintaining a system of internal accounting controls. In fulfilling this responsibility,

estimates and judgments by management are required to assess the expected benefits and related costs of control procedures. The objectives of a system are to provide management with reasonable, but not absolute, assurance that (1) assets are safeguarded against loss from unauthorized use or disposition and (2) transactions are executed in accordance with management's authorization and recorded properly to permit the preparation of financial statements in accordance with generally accepted accounting principles. Because of inherent limitations in any system of internal accounting controls, errors or irregularities may nevertheless occur and not be detected. Also, projection of any evaluation of the system to future periods is subject to the risk that procedures may become inadequate because of changes in conditions or that the degree of compliance with procedures may deteriorate.

Our study and evaluation was made for the limited purpose described in the first paragraph. It was more limited than would be necessary to express an opinion on the system of internal accounting controls taken as a whole or on any of the categories of controls specifically mentioned, and it would not necessarily disclose all material weaknesses in the system. Accordingly, we do not express an opinion on the system of internal accounting controls of the Corporation taken as a whole or on any of the categories of controls we identified. However, our study and evaluation of internal accounting controls disclosed no condition that we believed to be a material weakness. During the course of our examination, we did identify a number of opportunities for improving internal controls and procedures. We will communicate our findings to the Corporation through a separate management letter.

Report on Compliance With Laws and Regulations

We have examined the financial statements of the Federal Savings and Loan Insurance Corporation for the years ended December 31, 1985 and 1984, and have issued our opinion thereon. Our examinations were made in accordance with generally accepted government auditing standards and, accordingly, included such tests of the accounting records and such other auditing procedures, including tests of compliance with laws and regulations, as we considered necessary in the circumstances. This report pertains only to our review of compliance with laws and regulations for the year ended December 31, 1985. (Our report on compliance with laws and regulations for the year ended December 31, 1984, is presented in GAO/AFMD-85-60, July 16, 1985.)

In our opinion, the Corporation complied with the terms and provisions of laws and regulations for the transactions tested that could have materially affected its financial statements.

Nothing came to our attention in connection with our examination that caused us to believe that the Corporation was not in compliance with the terms and provisions of laws and regulations for those transactions not tested.

Financial Statements

Comparative Statement of Financial Condition

FOR THE YEARS ENDED DECEMBER 31, 1985 AND 1984

	1985	1984
<u>Assets</u>		
Cash.....	\$ 9,442,456	\$ 2,764,236
Investments (Note 3).....	6,127,967,733	5,869,307,301
Interest Receivable on Investments.....	46,870,463	58,296,395
Insurance Premiums and Other Receivables.....	36,043,267	37,803,382
Interest Receivable on Loans to Insured Institutions.....	1,659,202	4,157,244
Dividends Receivable on Net Worth Certificates	317,898	526,598
Subrogated Accounts from Receivers (Note 4).....	836,157,611	513,905,702
Collateralized Advances from Receivers (Note 4).....	368,831,140	582,681,309
Collateralized Loans to Insured Institutions (Note 5)	900,000,000	700,000,000
Other Loans to Insured Institutions (Note 5).....	133,304,928	222,349,947
Real Estate, Mortgage Loans and Other Assets in Process of Liquidation (Note 6).....	227,146,403	226,919,242
Income Capital Certificates (Notes 7 and 9).....	1,534,759,416	577,756,795
Net Worth Certificates (Notes 8 and 9).....	274,500,000	140,550,000
Other Assets (Notes 1 and 14).....	2,000,320	569,667
Total Assets	\$10,499,000,837 =====	\$ 8,937,587,818 =====
<u>Liabilities</u>		
Accounts Payable and Other Liabilities.....	\$ 30,544,476	\$ 55,679,776
Accrued Interest on Notes Payable.....	61,398,943	35,044,537
Notes Payable to Insured Institutions (Note 9)	2,619,651,777	834,834,936
Notes Payable to Federal Home Loan Banks (Note 5)....	900,000,000	700,000,000
Possible Losses Under Existing Assistance Agreements (Note 10).....	774,003,807	1,706,261,101
Estimated Contingent Liability (Note 13).....	1,556,000,000	-0-
Total Liabilities	\$ 5,941,599,003 =====	\$ 3,331,820,350 =====
<u>Insurance Fund Reserves</u>		
Primary Reserve	\$ 3,783,169,109	\$ 4,885,037,594
Secondary Reserve	774,232,725	720,729,874
Total Insurance Fund Reserves (Note 12)	4,557,401,834	5,605,767,468
Total Liabilities and Reserves.....	\$10,499,000,837 =====	\$ 8,937,587,818 =====

The accompanying notes are an integral part of these financial statements.

Financial Statements

Comparative Statement of Income and Expense and Reserves

FOR THE YEARS ENDED DECEMBER 31, 1985 AND 1984

	<u>1985</u>	<u>1984</u>
<u>Income</u>		
Insurance Premiums (Note 1).....	\$ 703,913,431	\$ 596,940,890
Special Assessment Premiums (Note 1).....	1,010,690,738	-0-
Interest on Investments.....	489,773,490	655,265,644
Interest on Other Loans to		
Insured Institutions.....	20,898,091	18,610,857
Interest on Collateralized Loans to		
Insured Institutions.....	61,562,233	23,785,878
Interest from Real Estate, Mortgage Loans and		
Other Assets in Process of Liquidation.....	25,677,623	18,412,484
Gain on Transfer of Insured Accounts.....	69,289,307	-0-
Other Income	<u>6,356,570</u>	<u>11,962,043</u>
Total Income.....	\$ 2,388,161,483	\$ 1,324,977,796
	=====	=====
<u>Expenses</u>		
Insurance Settlement and Administrative		
Expenses.....	\$ 31,157,546	\$ 22,900,706
Services Rendered to FSLIC by the		
Federal Home Loan Bank Board (Note 2).....	20,960,274	28,365,685
Interest Applied to the Secondary		
Reserve (Note 12).....	54,736,978	61,165,813
Interest on Notes Payable to Federal		
Home Loan Banks.....	59,099,555	23,785,879
Interest on Notes Payable to Insured		
Institutions.....	101,746,830	89,458,494
Provision for Possible Losses on:		
Subrogated Accounts from Receivers		
(Note 4).....	1,063,641,032	516,764,330
Collateralized Advances from Receivers		
(Note 4).....	229,738,768	60,127,729
Real Estate, Mortgage Loans and Other		
Assets in Process of Liquidation		
(Note 6).....	11,235,036	62,771,576
Loans to Insured Institutions (Note 5)....	5,650,000	-0-
Income Capital Certificates (Notes 7 and 9)	653,306,431	50,107,000
Net Worth Certificates (Notes 8 and 9)....	13,500,000	(4,750,000)
Assistance Agreements (Note 10).....	(310,742,482)	1,293,503,676
Estimated Contingency (Note 13).....	<u>1,556,000,000</u>	<u>-0-</u>
Total Expenses.....	\$ 3,490,029,968	\$ 2,204,200,888
	=====	=====
Net Income (Loss) From Operations.....	\$ (1,101,868,485)	\$ (879,223,092)
Reserves at Beginning of Year.....	5,605,767,468	6,425,421,524
Increase in Secondary Reserve (net) (Note 12)	<u>53,502,851</u>	<u>59,569,036</u>
Reserves at End of Year (Note 12).....	\$ 4,557,401,834	\$ 5,605,767,468
	=====	=====

The accompanying notes are an integral part of these financial statements.

Comparative Statement of Changes in Financial Position

FOR THE YEARS ENDED DECEMBER 31, 1985 AND 1984

Source of Funds:	1985	1984
Net Income (Loss).....	\$(1,171,868,485)	\$ (879,223,092)
Add (deduct) Items not Requiring, or Generating Cash:		
Depreciation of FF&E.....	99,834	27,019
Provision for Possible Losses on:		
Subrogated Accounts (Note 4).....	1,063,641,032	516,764,330
Collateralized Advances from Receiver (Note 4).....	229,738,768	60,127,729
Real Estate, Mortgage Loans and Other Assets (Note 6).....	11,235,036	62,771,576
Loans to Insured Institutions (Note 5).....	5,400,000	-0-
Income Capital Certificates (Notes 7 and 9)	653,306,431	50,107,000
Net Worth Certificates (Notes 8 and 9).....	13,500,000	(4,750,000)
Assistance Agreements (Note 10).....	(310,742,482)	1,293,503,676
Estimated Contingency (Note 13).....	1,556,000,000	-0-
Interest Applied to Secondary Reserve (Note 12)	54,736,978	61,165,813
Transfer to (from) Secondary Reserve (Note 12)	(129,443)	(1,438,798)
Accretion and Amortization on Investments....	(13,121,771)	(26,341,231)
Write Off of Other Receivables.....	250,000	-0-
Funds Provided from Operations.....	\$ 2,162,045,898	\$1,132,714,022
Increase in:		
Notes Payable and Accrued Interest.....	1,811,171,247	(11,049,670)
Notes Payable to FHLBanks.....	200,000,000	700,000,000
Decrease in:		
Accounts and Dividends Receivable.....	1,718,815	8,267,311
Total Funds Provided.....	\$ 4,174,935,960	\$1,829,931,663
	=====	=====
Application of Funds:		
Amount Paid Under Assistance Agreements.....	\$ 621,514,812	\$ 594,824,629
Secondary Reserve Refund (Note 12)	1,104,684	157,979
Increase in:		
Real Estate, Mortgage Loans & Other Assets...	3,167,421	62,865,885
Investments and Interest Receivable.....	242,407,505	(967,451,610)
Subrogated Accounts.....	1,385,892,941	787,593,979
Collateralized Advances from Receiver.....	15,888,599	642,809,038
Loans to Insured Institutions and Interest Receivable.....	113,856,939	714,323,995
Income Capital Certificates.....	1,610,309,052	(52,586,205)
Net Worth Certificates.....	147,450,000	67,650,000
Other Assets	1,530,487	460,868
Decrease in:		
Accounts Payable and Other Liabilities.....	25,135,300	(22,320,818)
Total Funds Applied.....	\$ 4,168,257,740	\$1,828,327,740
Increase In Cash	\$ 6,678,220	\$ 1,603,923
	=====	=====

The accompanying notes are an integral part of these financial statements.

Notes to Financial Statements

FOR THE YEARS ENDED DECEMBER 31, 1985 AND 1984

1. Summary of Significant Accounting Policies:

- a) General - These statements do not include accountability for assets and liabilities of closed insured institutions for which the Corporation acts as receiver or liquidating agent. Periodic and final accountability reports of its activities as receiver or liquidating agent are furnished by the Corporation to courts, supervisory authorities, and others as required.
 - b) Premium Income Recognition - Insurance premium income is recognized as earned when member institutions are assessed. The Corporation assesses insured institutions an insurance premium at the rate of 1/12 of one percent of their total savings capital. In addition to the normal insurance premium, the Bank Board has authorized the Corporation to assess each member an additional premium for insurance in an amount equal to 1/32 of one percent of their total savings capital each quarter. Because the additional insurance premium has no fixed term, a determination as to assessment is made by the Bank Board on a quarterly basis.
 - c) Provision for Loss Contingencies - Prior to 1985, the Corporation considered it impracticable to estimate its contingent liability for those troubled institutions which would likely require new or increased financial assistance. The Corporation established an estimated provision for loss only when the Bank Board approved assistance to an insured institution. The provision for loss represented the difference between the assistance provided and the expected amount of recovery, or the purchase price of the assets of a failed institution less the estimated recovery value, including all liquidation costs. These provisions were reviewed every quarter and adjusted to reflect projected interest rates, recent appraisals, and historical experience. As of December 31, 1985, the Corporation also estimated a contingent liability for troubled institutions that it believes will likely require new or increased financial assistance in the near term. The loss estimate was based on the Corporation's historical loss experience and an evaluation of the past and present financial condition of such institutions. This methodology focused on near term losses, and is not a projection of resolving all future problems in the savings and loan industry. The Corporation believes that with recapitalization of its reserve fund and its present borrowing authority, there are sufficient funds to provide needed assistance to troubled or failed institutions.
 - d) Furniture, Fixtures and Equipment - These assets are stated at cost less accumulated depreciation. Depreciation is computed on the straight-line method based on an 11-year useful life. The net balance of this account is insignificant and is included in Other Assets.
 - e) Reclassifications - Reclassifications have been made in the 1984 Financial Statements to conform to the presentation used in 1985.
2. Related Party Transactions - The Federal Home Loan Bank Board is an independent Federal agency in the executive branch of government and governs the insurance of accounts in savings and loan associations and federal savings banks through the FSLIC. Bank Board expenses are met through assessments to the FSLIC and FHLBanks. The FSLIC expenses its share of the Bank Board assessment for operating expenses during the year in which the assessment is levied.

2. (Cont.)

In addition to Bank Board related transactions, the FSLIC, as part of its default prevention activities, may guarantee repayment of FHLBank advances that were made to certain insured institutions. These guarantees generally cover advances that are secured. The amount of these advances as of December 31, 1985 and 1984 totaled \$2,064 million and \$1,715 million respectively. In the event that it is called upon to honor these guarantees, the FSLIC records them as an asset, Collateralized Advances from Receiver, and has claim against any assets pledged as collateral to secure such advances. (See Note 4).

The FHLBanks are also authorized, as directed by the Bank Board, to make loans to the FSLIC. All such loans shall be in accordance with the provisions of section 402(d) of the National Housing Act. Loans from FHLBanks at December 31, 1985 and 1984 were \$900 million and \$700 million respectively, and have been passed through to member institutions as Collateralized Loans (See Note 5).

3. Investments - Investment securities are stated at cost, adjusted for amortization of premiums and accretion of discounts. Such amortization and accretion are computed on the interest method at rates based upon the maturity dates of the related securities. Both amortization and accretion are recognized as an adjustment to Interest on Investments.

All cash received by the Corporation which is not used to defray operating expenses or for outlays related to assistance to insured institutions and liquidation activities, is invested in U.S. Treasury securities. Other Investments are mostly securities issued by Federal Government Agencies other than the U.S. Treasury which were obtained through the Corporation's default prevention activities.

As of December 31, 1985 and 1984, the Corporation's investment portfolio consisted of the following:

	<u>1985</u>		<u>1984</u>	
	<u>Book Value</u>	<u>Market Value</u>	<u>Book Value</u>	<u>Market Value</u>
	<u>(in thousands)</u>		<u>(in thousands)</u>	
U.S. Treasury Securities:				
Overnight Funds	\$ 1,217,419	\$ 1,217,419	\$ 2,334,219	\$ 2,334,219
Maturities up to				
One Year	3,614,358	3,614,033	542,497	545,407
Maturities Over One				
Year	<u>1,229,501</u>	<u>1,162,927</u>	<u>2,164,708</u>	<u>1,881,044</u>
Subtotal	<u>6,061,278</u>	<u>5,994,379</u>	<u>5,041,424</u>	<u>4,760,670</u>
Other Investments:				
Maturities Up to One				
Year	-0-	-0-	125	119
Maturities Over One				
Year	<u>66,689</u>	<u>63,584</u>	<u>827,758</u>	<u>756,045</u>
Subtotal	<u>66,689</u>	<u>63,584</u>	<u>827,883</u>	<u>756,164</u>
Total:	\$ 6,127,967	\$ 6,057,963	\$ 5,869,307	\$ 5,516,834
	=====	=====	=====	=====

4. Subrogated Accounts and Collateralized Advances - As required by Statute, an institution is closed only when there is no default prevention measure that would be less costly than liquidation. In these cases, FSLIC settles insurance claims either by cash payout of insured accounts or by transferring insured accounts to another insured institution. FSLIC's claims on the Receivership of the liquidated institution are equal to the amount of the insured accounts transferred and/or the Collateralized Advances paid. Insured deposits give rise to Subrogated Accounts and FHLBank advances (See Note 2) give rise to Collateralized Advances.

In most cases a Receivership does not have sufficient assets to pay all of its claims; therefore, FSLIC must estimate how much of each claim will be recovered over the life of the Receivership and record the difference as an allowance for loss against the claim. In 1985 future cash inflows from Receiverships to the FSLIC were discounted to their present value resulting in an additional \$236.6 million increase in the allowances for these two accounts.

The changes in Subrogated Accounts and Collateralized Advances for the years ended December 31, 1985 and 1984 are.

	<u>Subrogated Accounts</u>		<u>Collateralized Advances</u>	
	<u>1985</u>	<u>1984</u>	<u>1985</u>	<u>1984</u>
	(in thousands)		(in thousands)	
Balance, Beginning of Year	\$ 1,156,502	\$ 351,876	\$ 642,809	\$ -0-
Add: Increase During Year	1,368,868	804,626	12,760	642,809
Balance, End of Year	<u>2,525,370</u>	<u>1,156,502</u>	<u>655,569</u>	<u>642,809</u>
Less: Allowance for Possible Losses (Cumulative)	<u>1,689,213</u>	<u>642,597</u>	<u>286,738</u>	<u>60,128</u>
Net, End of Year	<u>\$ 836,157</u>	<u>\$ 513,905</u>	<u>\$ 368,831</u>	<u>\$ 582,681</u>
	=====	=====	=====	=====

5. Loans to Insured Institutions - The FSLIC makes both collateralized and other types of loans in assistance cases. The collateralized loans have been funded by pass-through loans from FHLBanks. In these transactions, FSLIC issues a Note Payable to the FHLBank and loans the proceeds to an insured institution. The FSLIC has two loans of this type, totaling \$900 million. Interest rates on the \$200 million loan to an insured institution and the corresponding note to the FHLBank are the same and averaged 8.2% in 1985. Interest rates on the remaining \$700 million loan to an insured institution is based on the monthly weighted-average cost of funds charged to members of the FHLBank in which the insured institution is located and ranged from 10.2% to 8.9% in 1985. Interest on the corresponding Note to the FHLBank is based on the cost of FHLBank funds plus 20 basis points which varied between 10.9% and 7.6% during 1985. Annual principal payments on the collateralized loans begin in 1988 and end in 1995.

The \$133.3 million in Other Loans to Insured Institutions is shown net of a \$5.4 million allowance which was established in 1985. The interest rate on these loans varies with each note. There was no allowance in 1984.

6. Real Estate, Mortgage Loans and Other Assets - The FSLIC makes direct acquisitions of troubled assets from problem associations in its attempt to merge a failing institution. The vast majority of these assets consists of real estate and mortgage loans.

6. (Cont.)

The changes in Real Estate, Mortgage Loans and Other Assets in Process of Liquidation for the years ended December 31, 1985 and 1984 are:

	<u>1985</u> (in thousands)	<u>1984</u>
Balance, beginning of year	\$ 296,677	\$ 253,142
Increase (decreases) during year	<u>(38,928)</u>	<u>43,535</u>
Balance, End of Year	257,749	296,677
Less Allowance for Possible Losses (Cumulative)	<u>30,603</u>	<u>69,758</u>
Net, End of Year	\$ 227,146 =====	\$ 226,919 =====

7. Income Capital Certificates - Since 1981 the FSLIC has purchased Income Capital Certificates (ICC's) from insured institutions as part of its default prevention activities. The FSLIC usually purchases an ICC by issuing a note payable and records the ICC at cost (Note 9). The ICC's earn annual income payments based on the United States Treasury Bill rates. The annual income payments and principal are redeemable upon the issuing institution having profitable operations and attaining a specified net worth level. The major increase (\$1.5 billion) in the ICC's purchased is a result of the FSLIC's management consignment program.

The changes in the ICC's for the years ended December 31, 1985 and 1984 are:

	<u>1985</u> (in thousands)	<u>1984</u>
Balance, Beginning of Year	\$ 720,614	\$ 773,200
Add: Net Purchases (Decrease) During Year	<u>1,610,309</u>	<u>52,586</u>
Balance, End of Year	2,330,923	720,614
Less: Allowance for Possible Losses (Cumulative)	<u>796,164</u>	<u>142,857</u>
Net, End of Year	\$ 1,534,759 =====	\$ 577,757 =====

8. Net Worth Certificates - Since 1982 the FSLIC has purchased Net Worth Certificates (NWC's) from insured institutions as part of its default prevention activities. The FSLIC purchases an NWC by issuing a note payable and records the NWC at cost (Note 9). NWC's earn annual income payments based on the cost of Federal Home Loan Bank System Obligations plus 1/4 of one percent. Annual income and principal payments are redeemable upon the issuing institution having profitable operations and attaining a specified net worth level. Such payments have been accrued for institutions meeting these requirements while other institutions have already made payments.

8. (Cont.)

The changes in the NWC's for the years ended December 31, 1985 and 1984 are:

	1985	1984
	(in thousands)	
Balance, Beginning of Year	\$ 144,550	\$ 76,900
Add: Purchases During Year	147,450	67,650
Balance, End of Year	292,000	144,550
Less: Allowance for Possible Losses (Cumulative)	17,500	4,000
Net, End of Year	\$ 274,500	\$ 140,550
	*****	*****

9. Notes Payable to Insured Institutions - The FSLIC has outstanding negotiable notes to purchase ICC's and promissory notes to purchase ICC's and NWC's. Variable interest is paid semiannually based on the cost of Federal Home Loan Bank System Obligations or the average auction yield for United States Treasury Notes with maturities from 5-10 years. In addition to issuing notes to purchase ICC's and NWC's, the FSLIC has also issued other negotiable notes to carry out its default prevention activities.

The aggregate amount of the Notes Payable to Insured Institutions as of December 31, 1985 is as follows:

	ICC's	(in thousands) NWC's	Other	Total
1986	\$ -0-	\$ -0-	\$ 3,622	\$ 3,622
1987	144,000	5,000	21,000	170,000
1988	98,900	-0-	40,074	138,974
1989	-0-	-0-	-0-	-0-
1990	1,410,917	-0-	325,139	1,736,056
Later	292,000	279,000	-0-	571,000
Total	\$ 1,945,817	\$ 284,000	\$ 389,835	\$ 2,619,652
	*****	*****	*****	*****

10. Assistance Agreements - The FSLIC enters into these agreements, which are usually associated with mergers, to prevent the default of an insured institution. The estimated liability under these agreements declined during 1985 due to two major reasons: a) lower interest rate projections and b) a change in estimating this liability from actual future cash outlays to discounted (present value) cash outlays. The changes in Possible Losses Under Existing Assistance Agreements for the years ended December 31, 1985 and 1984 are:

	1985	1984
	(in thousands)	
Balance, Beginning of Year	\$ 1,706,261	\$ 1,007,582
Provision Charged (Credited) to Expense	(310,742)	1,293,504
Less: Assistance Paid	621,515	594,825
Balance, End of Year	\$ 774,004	\$ 1,706,261
	*****	*****

11. Retirement Plan - Substantially all of the FSLIC employees are covered by the Civil Service Retirement System, which is currently two-tiered. For employees hired prior to January 1, 1984, the FSLIC withholds approximately 7 percent of their gross earnings. Their contribution is then matched by the FSLIC and the sum is transferred to the Civil Service Retirement Fund, from which this employee group will receive retirement benefits. For employees hired on or after January 1, 1984, the FSLIC withholds, in addition to social security withholdings, approximately 1.3 percent of their gross earnings, but matches such withholdings with a 7 percent contribution, as above. This second employee group will receive retirement benefits from the Civil Service Retirement System along with the Social Security System, to which they concurrently contribute. The retirement plan expenses incurred for calendar years 1985 and 1984 were \$346,838 and \$258,366 respectively.

Although the FSLIC funds a portion of pension benefits under the Civil Service Retirement System relating to its employees and makes the necessary payroll withholdings from them, the FSLIC does not account for the assets of the Civil Service Retirement System nor does it have actuarial data with respect to accumulated plan benefits or the unfunded pension liability relative to its employees. These amounts are reported by the Office of Personnel Management for the Retirement System and are not allocated to the individual employers.

12. Reserves - The FSLIC's total reserves available for losses consist of the Primary and Secondary Reserves. The Primary Reserve is the cumulative net income of the FSLIC since its inception less the interest applied to the Secondary Reserve. The Secondary Reserve is the equity of certain institutions in FSLIC based on premium prepayments and related interest not yet paid to these institutions. It is available for absorbing losses, but may also be paid back to the institutions depending on FSLIC's financial condition and management's anticipation of losses. Interest was credited to the Secondary Reserve based on the geometric yield of FSLIC's investment portfolio.

	1985	1984
	(in thousands)	
<u>Primary Reserve</u>		
Balance, Beginning of Year	\$ 4,885,037	\$ 5,764,260
Net Income (Loss)	(1,101,868)	(879,223)
Balance, End of Year	3,783,169	4,885,037
<u>Secondary Reserve</u>		
Balance, Beginning of Year	720,730	661,161
Interest Applied	54,737	61,166
Transfers and Refunds	(1,234)	(1,597)
Balance, End of Year	774,233	720,730
Total Reserves at End of Year	\$ 4,557,402	\$ 5,605,767
	=====	=====

13. Estimated Contingent Liability - As discussed in Note 1, in 1985, the Corporation changed its method of accounting for estimated losses for troubled savings and loans that would likely need new or additional financial assistance in the near term. This change required consistent application through a restatement of the prior year's financial statements. However, since the Corporation considered it impracticable to determine the effect on the 1984 and prior year's financial statements, the cumulative effect of the change has been included in the Provision for Losses for the year ended December 31, 1985.

14. Federal Asset Disposition Association - In November 1985, the Bank Board approved the formation of the Federal Asset Disposition Association, or FADA, frequently termed the "406 Corporation". The FADA, which is a wholly owned subsidiary of the FSLIC, will manage and dispose of assets received by the FSLIC in case resolution actions. The FADA is a further refinement by the Bank Board in fulfilling its obligation to protect FSLIC resources by operating in an efficient and cost-effective manner, prudently using premium dollars to resolve FSLIC problems. As of December 31, 1985, the FSLIC had purchased 1,000 shares of FADA common stock for \$1 million. The purchase was recorded using the equity method and is included in Other Assets.

Subsequent to December 31, 1985, the FSLIC has purchased \$24 million in additional shares of FADA common stock; and the FADA's board of directors selected a highly qualified chief executive officer who is gathering the staff necessary to begin operations.

15. Subsequent Event - The Congress is currently considering legislation titled, "The Federal Savings and Loan Insurance Corporation Recapitalization Act of 1986" (S.2491; H.R. 4907) to strengthen FSLIC's insurance fund reserves through a newly created "Financing Corporation". The Bank Board would be required to charter the Financing Corporation as a "mixed ownership" government corporation. The Financing Corporation would be owned by the FHLBanks and would begin operations with capital provided by the FHLBanks.

The Financing Corporation would be used as the means of financing equity transfer to the FSLIC. This will be accomplished by empowering FSLIC to issue equity in the forms of redeemable non-voting capital stock and non-redeemable capital certificates. The non-voting capital stock would be issued in an amount equal to the aggregate investment by the FHLBanks in the Financing Corporation. The Financing Corporation would be the sole purchaser of both the capital certificates and the capital stock issued by the FSLIC. Proceeds paid to the FSLIC would be included as part of the Corporation's primary reserve.

It is expected that the Financing Corporation's capital base be leveraged by issuing \$5 in long term bonds for every \$1 in capital infused from the Federal Home Loan Banks. Preliminary estimates assume that at least \$3 billion capital would be infused, raising about \$15 billion in funds for transfers to the FSLIC.

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